Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Chu | Analyst: John Pavalasky | Bill Number: AB 2109

Related Bills: See Legislative History | Telephone: 845-4335 | Amended Date: May 17, 2004

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Water's Edge Election/Inverted Corporations

SUMMARY

This bill would provide that the income and apportionment factors of certain foreign incorporated entities (i.e., "inverted domestic corporations") remain subject to California tax if a water's-edge election is made.

SUMMARY OF AMENDMENTS

The May 17, 2004, amendments struck out the previous contents of the bill and added new language that would include the income and apportionment factors from an affiliated "inverted domestic corporation" in the water's-edge combined reporting group for California tax purposes. This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to ensure that inverted domestic entities, i.e., former U.S. based corporations and partnerships that have converted themselves to foreign-country based corporations, pay their fair share of California taxes.

EFFECTIVE/OPERATIVE DATE

This bill would apply to corporations making a water's-edge election on or after January 1, 2004, and to corporations that currently have a water's-edge election in effect, but not until the expiration of the current term (seven years) of that water's-edge election.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve any implementation, technical, or policy concerns that arise as the bill moves through the legislative process.

ANALYSIS

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Gerald H. Goldberg	6/14/04
_______ N	_______ OUA	___X___ PENDING		

FEDERAL/STATE LAW

Taxation of Domestic Corporations

Under current federal tax law, U.S. (domestic) corporations are taxed on their worldwide income. If a U.S. corporation has income from activities in foreign countries, then that country typically will tax the income sourced to that country. To the extent the U.S. would treat that income as arising from activities in foreign countries, it generally allows a credit for taxes against the corporation's federal income tax liability for the taxes paid to the foreign countries on such income. A U.S. corporation, therefore, typically has income from its foreign operations taxed both here and in the foreign country in which that income was earned.

If a U.S. corporation conducts its business activities in a foreign country through subsidiaries, U.S. taxation of that foreign-earned income normally only happens when that income is received by the U.S. parent corporation in the form of a dividend paid by the foreign subsidiary. In order to combat tactics designed to convert what would normally be U.S. income to income reported by a foreign subsidiary, a series of complex anti-deferral rules (Subpart F of the Internal Revenue Code) were enacted to prevent the deferral of U.S. tax until the foreign subsidiary paid a dividend to the U.S. parent corporation. A foreign tax credit is allowed by the U.S. at the time dividends are paid, or deemed paid, by a foreign subsidiary to the U.S. parent. If a dividend is never paid, or is not deemed to be paid, to the U.S. parent by a foreign subsidiary, the income of the foreign entity is never subject to U.S. tax.

For example, Group A (a U.S.-based multinational group) produces goods and/or services in the U.S. and abroad, and a foreign-based multinational group (Group B) produces exactly the same things, in the same amounts, for the same prices, in the same places as Group A. In many cases, Group B will incur a lower U.S. tax bill, and in many cases a lower overall tax bill than Group A (the U.S-based group). This occurs first because all of the income of Group A will ultimately be subject to U.S. tax, while only the U.S. source income of Group B will be subject to U.S. tax. Second, it occurs because of tax rate differentials between the U.S. and some foreign countries.

These federal tax disadvantages have caused some U.S.-based multinational corporations with foreign-earned income to reincorporate and relocate their domiciles abroad. This transformation is accomplished by reincorporating in an appropriate foreign location, such as Bermuda or the Cayman Islands, typically by having a firm’s foreign subsidiary exchange its shares for those of the American parent company. Individual shareholders, who previously owned shares of the American parent company, will then own shares of the foreign (parent) company, which in turn owns the shares of the American company. These transformations are known as corporate inversions.

Taxation of Foreign Corporations

The U.S. taxes foreign corporations only on income that has a sufficient nexus to the U.S. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the U.S. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the U.S.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30% rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

Earnings Stripping

If structured properly, a corporate inversion can be used to reduce a company's taxes on domestically earned income (commonly called earnings stripping). This may be accomplished in several ways. In some inversion transactions the U.S. company issues debt to its foreign parent company in exchange for additional equity in the foreign company. The domestic firm can then deduct from its taxable income the interest expenses associated with the debt. However, since the U.S. corporation owns equity in the foreign company, the overall value of the domestic company does not change.

Another method of reducing a company's tax burden is to transfer ownership of intangible assets to the new foreign parent company. These assets continue to produce income in the U.S., but that income is attributed to the foreign parent company that owns the intangible asset and faces a lower tax rate.

<u>Current California Law</u>

Worldwide Combined Reporting

Under current California law, California source income for unitary businesses that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state measured by property, payroll, and sales. Where the business is incorporated (i.e., foreign or domestic) generally does not have a material effect on the California tax liability of the business under worldwide combined reporting.

Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge," or inside of the U.S., basis. Under a water's-edge election, all the income of U.S. incorporated entities and a portion of the income of foreign incorporated entities doing business in the U.S. is included in the combined report, which is then apportioned geographically by use of the three-factor formula. Generally unitary foreign affiliates are excluded from the combined report used to determine income derived from or attributable to California sources. Thus, the income assigned to foreign corporations is generally not included within the water's-edge combined report. Taxpayers are required to maintain their water's-edge election or to remain on the worldwide basis for at least seven years unless the taxpayer requests and receives permission to change from the Franchise Tax Board.

See Attachment I for a graphical comparison of the taxation of domestic and foreign corporations having identical operations.

THIS BILL

This bill, once fully implemented, would eliminate the impact of corporate inversions for California tax for water's-edge electors. This would be done by treating a foreign incorporated entity that meets the definition of an "inverted domestic corporation" as a domestic corporation for purposes of a water's-edge election. That is, it would include the income and apportionment factors from an affiliated "inverted domestic corporation" in the water's-edge combined reporting group for California tax purposes.

An "inverted domestic corporation" is defined as a foreign incorporated entity that acquires the property of a domestic corporation or specified partnerships if:

1. Immediately after the acquisition:
   - More than 50% of the stock is held by former shareholders (or partners) of the domestic corporation (or partnership), or
   - More than 50% of the stock is held by domestic shareholders; and
2. It meets an asset test.

Under the asset test, the assets of the domestic corporation or partnership must be at least 80% of the assets of the resulting foreign incorporated entity. That test would ensure that foreign corporations with other substantial assets are not adversely affected.

This bill would also authorize the Franchise Tax Board to prescribe legislative regulations to treat warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock and to treat certain stock as not being stock.

IMPLEMENTATION CONSIDERATIONS

The definition of "inverted domestic corporation" contains new and untested rules that are very complex and that may need further development. The department will work with the author to address this concern as the bill moves through the legislative process.

LEGISLATIVE HISTORY

SB 640 (Burton, Stats. 2003, Ch. 657) prohibits the state from entering into any contract with a publicly traded foreign incorporated entity or its subsidiary if that business meets certain conditions that would make it an expatriate company (a domestic corporation or partnership that incorporated in a foreign jurisdiction in name only).

SB 1061 (Senate Rev & Tax Committee, Stats. 2003, Ch. 633), a Franchise Tax Board sponsored bill, fundamentally reforms the water's-edge election procedures to resolve problems that arose with elections made under the previous contract rules. Under SB 1061, water's-edge elections are made and treated as if made by statutory election rather than by contract.

SB 1067 (Speier, 2003/2004), sponsored by the Treasurer of California, would include the income and apportionment factors from an affiliated "inverted domestic corporation" in the water's-edge combined reporting group for California tax purposes. That bill failed to pass out of the house of origin.

AB 2584 (Chu and Levine, 2003/2004), sponsored by the Treasurer of California, is essentially the same as AB 2109 and would include the income and apportionment factors from an affiliated “inverted domestic corporation” in the water’s-edge combined reporting group for California tax purposes. That bill is in the Assembly Appropriations Committee.

PROGRAM BACKGROUND

As stated in the Senate Judiciary Committee analysis of SB 640 (Burton, Stats. 2003, Ch. 657), Congressional hearings on corporate inversions or expatriations were held in 2002 in connection with the Homeland Security Act then being debated in Congress. The hearings centered on whether an American company should be allowed to take advantage of tax benefits when it reincorporates in a foreign jurisdiction where the corporate tax rates are lower.

The Assistant Secretary for Tax Policy, U.S. Department of the Treasury, during congressional testimony defined a corporate inversion (also known as expatriation) as a "transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group."

During that testimony before Congress, the Assistant Secretary also stated that the restructuring steps involving movement of foreign subsidiaries are complex and are taxable. When all the transactions are complete, however, the foreign operations of the company will be outside of the U.S. taxing jurisdiction and the corporate structure may also provide opportunities to reduce the U.S. tax on U.S. operations. Thus, she stated, U.S.-based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available.

The problem is accentuated by the fact that many U.S. corporations have in fact gone global, with income and profits coming from business ventures around the world, and the taxation scheme of the U.S. tax code has encouraged many of them to be "creative" in seeking ways to minimize taxes.

The Senate Judiciary Committee analysis of SB 640 (Burton, Stats. 2003, Ch. 657), stated that:

> Early last year, news about Stanley Works, for example, seeking to reincorporate in Bermuda to save some $30 million in U.S. taxes when it only paid $7 million in U.S. taxes on foreign income last year, led to the conclusion that three quarters of the anticipated tax savings would have come from U.S. profits. Amid the hue and cry, Stanley Works stayed as a Connecticut corporation.
>
> More recently, Ingersoll-Rand, formerly of New Jersey but now operating as a Bermuda corporation, is reported to have avoided $50 million in U.S. taxes alone in 2002, almost as much as its U.S. defense and homeland security federal contracts. Thus, the outcry to restructure the tax code to recapture these taxes, and to force domestic companies to stay in-country led to various measures proposed in Congress last year, though none was actually passed. Rep. Neal, in reintroducing his measure in Congress this year, stated that corporate expatriation is a $4 billion problem for the federal treasury.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, Montana, New York,* and *North Dakota.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

1. Florida begins the computation of the Florida tax base with federal taxable income. An adjustment is required where the membership of the Florida affiliated group included in the Florida consolidated return differs from the membership in the federal affiliated group included in the federal consolidated return. The federal taxable income for the Florida affiliated group must be computed by adjusting for the difference, if any, between the income of the Florida and federal affiliated groups, including all intercompany adjustments and eliminations required under federal law. In addition, the Florida tax base excludes the following:

- Income from sources outside of the U.S.
- Subpart F income.
- Dividends received from certain foreign corporations by domestic corporations choosing to use the foreign tax credit for federal purposes.

Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Florida affiliated group's tax base.

2. Illinois begins its computation of the Illinois unitary group's tax base with federal taxable income. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Illinois unitary group's tax base. In addition, Illinois excludes from the unitary group any corporation having 80% or more of its total business activity outside of the U.S. (the 80/20 rule).

3. Massachusetts allows corporations filing federal consolidated returns to elect to file a combined return in that state. Taxable income must be determined and apportioned separately for each affiliated corporation and then combined to arrive at the group's net income subject to tax.

Taxable income for Massachusetts purposes is the same as that defined under the federal Internal Revenue Code (IRC) as amended and in effect for the taxable year, modified by adding back the interest from bonds, notes, and evidences of indebtedness of any state (including Massachusetts). However, the dividends received deduction and the deduction for income or franchise taxes are not allowed in computing Massachusetts taxable income. Federal modifications to each corporation's separate taxable income, generally including the eliminations and deferrals listed in Treasury Reg. Sec. 1.1502, are not recognized by Massachusetts. The taxable income amount for each corporation must be adjusted to reverse any of those modifications.

Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Massachusetts combined group's tax base since a foreign corporation cannot be included in a federal consolidated return.

4. Michigan does not recognize the unitary method of taxation. Only firms actually engaged in business activity in Michigan are subject to the Michigan single business tax (SBT). A foreign subsidiary or parent corporation with no Michigan business activity is not subject to SBT. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Michigan business income component of the SBT tax base.

One of the components of the SBT is business income (which equals taxable income as defined for federal tax purposes) and additions or subtractions to business income.

- Additions include depreciation, taxes based on income, net operating loss carryover or carryback, and any dividend, interest, and certain royalty expenses taken on the federal return.
- Subtractions include dividend, interest, and certain royalty income reported on the federal return.

Firms doing business in Michigan and in other states apportion their tax base to Michigan using a formula based on their percentage of property, payroll, and sales in Michigan. Financial organizations and transportation companies use a single factor formula based on gross business and revenue miles, respectively.

5. Minnesota requires a unitary group to file a combined return. A combined return for Minnesota may only include domestic corporations excluding insurance companies and investment companies. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the Minnesota tax base. Foreign corporations and investment companies that have nexus with Minnesota, even if they are part of a unitary group, must file separate tax returns. In addition, Minnesota excludes from the unitary group (and treats as a foreign corporation) any corporation having 80% or more of its total business activity outside of the U.S. (the 80/20 rule).

6. Montana enacted legislation that, starting in tax year 2004, changes the manner in which it taxes corporations electing to file under the “water’s edge” method of income apportionment. That change requires that the corporation’s return include the income and apportionment factors for any corporation that is in a unitary relationship with the filing corporation and that also is incorporated in a “tax haven.” The “tax havens” are specified in the statute to include Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Turks and Caicos Islands, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxemburg, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, U.S. Virgin Islands, and Vanuatu.

7. The New York tax base equals federal taxable income modified for income and deduction items that New York treats differently. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the New York tax base.

New York uses a three-factor formula to allocate business income. The factors include property, payroll (excluding general executive officers), and receipts, with the latter factor being double weighted. Taxpayers allocate investment income by a formula that reflects the New York presence of the issuers of the obligations generating the investment income. In addition, New York’s tax base excludes subsidiary income items and does not allow deductions directly and indirectly attributable to subsidiary capital.

8. In 2003, North Dakota legislation (SB 2054 and HB 1471) was introduced that proposes a flat North Dakota corporate income tax rate of 6.84% and 6.73%, respectively. Currently, the corporate income tax rate ranges from 3% on the first $3,000 to 10.5% on all taxable income above $50,000. SB 2054 would reduce the current rate to 9.9% for corporations making a water’s-edge election, while HB 1471 would repeal the water’s-edge election provisions.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Projected revenue gains for this bill will increase over time as shown in the table below:

Fiscal Year Cash Flow Impact Enactment Assumed After 6/30/04 $ Millions				
2004-5	2005-6	2006-7	2007-10	2010-14
0	0	0	0	+60

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Revenue Discussion

In recent years, several corporations have moved their headquarters out of the U.S. to reduce their taxes. These relocations enable certain income to be attributed to the jurisdiction of the headquarters and, thus, to be shielded from U.S. taxation. California law allows corporations to elect the water's-edge method for determining the amount of income taxable by California. That method can shield income from taxation because, unlike the alternative of world-wide reporting, it excludes the income and factors of foreign incorporated related entities from a corporation's tax calculation. AB 2109 would require that, under certain conditions, corporations that invert (move their headquarters out of the U.S.) must treat their income and factors from "an inverted domestic corporation" (i.e., their headquarters corporation) as inside the water's-edge for California tax purposes. This income would, therefore, not be shielded from taxation.

Corporations with a water's-edge election in effect on January 1, 2004, would not be required to include their income and factors in the water's-edge until that election expires in 2010. Therefore, there will be no revenue impact from already inverted corporations until that time. New corporate inversion activity appears recently to have abruptly halted. In fact, one corporation that was well along in the process of inverting, Stanley Works, reversed its decision and is not inverting. Under the current political climate, we are not aware of any corporations currently attempting to invert. We are therefore assuming that this bill will have no revenue impact until 2010. (Note that this differs from a similar analysis for SB 1067 (Speier, 2003/2004) last year that assumed corporate inversions would continue to occur at roughly the same pace as inversions in the previous several years).

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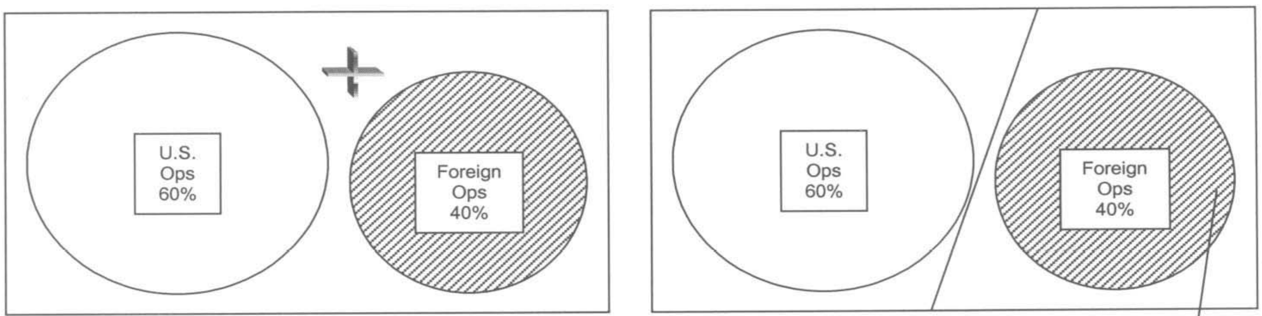
ATTACHMENT I - COMPARISON OF TAXATION OF DOMESTIC VERSUS FOREIGN CORPORATIONS

U.S. Incorporated Corporation or U.S. Parent
(Domestic)

Foreign Incorporated Corporation or Foreign Parent
(Foreign)



U.S. Taxes
100% of Net Income
Offset With Foreign Tax Credit

U.S. Taxes
Only Net Income From U.S. Operations
60% of Total Net Income

Current Law

DOMESTIC REINCORPORATES
OFFSHORE BY CREATING FOREIGN HOLDING COMPANY – IN NAME ONLY – NO SIGNIFICANT CHANGE IN OPERATIONS

CURRENT FEDERAL IMPACT
1. 40% of Income Now Foreign and not taxed
2. Opportunity to Convert Intangible Income From US Source to Foreign Source Income.
3. Allows Foreign Parent to Charge Fees Deductible Against US Source Income but Income to Parent is Not Taxed.

CALIFORNIA IMPACT

California Impact – Substantial Under
Water's Edge Combined Report
1. 40% of Income Not Taxed and Foreign Factors Not Included Within Water's Edge
2. Opportunity to Convert Intangible Income From US Source to Foreign Source Income.
3. Allows Foreign Parent to Charge Fees Deductible Against US Source Income but Income to Parent is Not Taxed.

California Impact – None Under
World Wide Combined Report
100% of Income Subject to Apportionment
100% of Factors Included In Formula

AB 2109

AB 2109 RESULT
INVERTED DOMESTIC CORPORATION IS TREATED AS IF IT STILL WAS A DOMESTIC CORPORATION
100% of Income Inside the Water's Edge
100% of Factors Included Within Water's Edge